

The COMPASS Chronicle

Winter 2016

Highlighting important wealth management issues

Optimizing A Retirement Portfolio For Taxation

Locating investments in the right type of account can make a big difference in your retirement savings and lifestyle.

Here's the story, told through an example of a hypothetical couple — Jodi and Mark — with \$1 million in savings. Their tax-advantaged IRA accounts hold \$360,000 in stocks and stock mutual funds, plus another \$240,000 in taxable bonds. Jodi and Mark's taxable account holds \$400,000, with 60% in stocks returning 10% annually in capital gains and 40% in muni bonds yielding 3.6% of income.

- combined state and federal tax rate of 40% on income

- capital gains rate of 20%

After five years, the after-tax value of the taxable account is \$548,000 and the IRA's after-tax value grows to \$541,000 — a total of \$1,089,000.

But now look at what happens when you apply a little strategic tax planning by employing a strategy to optimize the location of your investments to minimize taxes.

Optimizing for location would place all \$400,000 in the taxable account in stocks to benefit as much

COMPASS Corner

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Welcome to the latest iteration of *The COMPASS Chronicle*. This newsletter, which we expect will

highlight investment and financial planning issues relevant to your life, will be sent to you automatically each quarter. Feel free to forward it to your family or friends who may have interest. If they would like to be added to our e-mail distribution list, ask them to forward an e-mail to me at lconrad@compassinvest.com and have them ask to "Subscribe" to our newsletter—I will ensure they are added to our distribution list.

The COMPASS Corner will be our firm's place to update you on COMPASS' activities, capital market or economic summaries, or other relevant issues potentially impacting your financial life. We encourage your feedback, including issues you would like addressed in this newsletter. We have partnered with a firm with longstanding experience in providing insightful articles to advisors for the enrichment of their clients. This quarter's *COMPASS Chronicle* includes articles on asset location, tax implications of investing, Social Security, and custodial versus Section 529 accounts.

We hope you enjoy the latest *Chronicle*.



To keep it real, let's make these very reasonable assumptions:

- bonds yield 6% of income annually
- stocks return a 10% capital gain annually
- residents of a state with high-income tax

as possible from the 20% favorable capital gains rate. Why settle for income from the muni bonds of 3.6%, when the after tax-return on stocks annually over the long run has averaged 8%? Meanwhile, optimizing the \$600,000 IRAs would

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Compare Minor's Account To 529 Plan

Until the Section 529 college savings plan came along, parents looking ahead to the high cost of college for their children often set up accounts under their states' Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). But the broad benefits of 529 plans have made them more popular than UGMAs and UTMAs in recent years. Here's how the two saving vehicles compare:

UGMA/UTMA accounts: These are custodial accounts to which you contribute money for a minor's benefit. As the custodian, you control the investments until the child reaches age 18 or 21, depending on the laws of your state.

However, for tax purposes, any earnings on account assets are taxed to your children at their lower tax rates. For 2016, the first \$1,050 of earnings in a custodial account is tax-free and the next \$1,050 is taxed at the child's rate. But earnings beyond \$2,100 are generally subject to the so-called kiddie tax—they're taxed at the parents' top rate. And whether you pay or your child pays that tax, it creates an

annual drain on the account during the years you're trying to build up funds for college.

Section 529 plans: With this type of state-sponsored plan, you contribute to an account for which you name your child as beneficiary. Then you're in charge of how the money is invested (though only among the options the plan offers, and the ability to switch investments is limited). Unlike in a custodial account, earnings from investments aren't taxed while they're accumulating. And distributions from the plan that go to pay qualified college expenses, such as tuition, also aren't taxed.

Those provisions give 529 plans a dramatic advantage over a custodial account. There aren't any kiddie tax complications with a 529 because the growth in the account you've set up for your child isn't taxed at all during the years leading up to college. And whereas you may owe capital gains tax

when you sell investments in a custodial account to pay college expenses, that doesn't happen when you take money from a 529 to pay for college.

In addition, if your kids have a custodial account, they get control of the money once they reach the age of majority in your state—and they can use it any way they want, not just for college. That doesn't happen with a Section 529 plan—you stay in control of the account regardless of the age of the beneficiary.

A final disadvantage of a custodial account is that it may hurt a student's eligibility for federal financial aid because it counts as that student's asset, not that of the parents. Section 529 plans, in contrast, are treated as if they belong to the parents and aren't likely to affect financial aid eligibility.

So while there may be situations in which a custodial account makes sense in saving for college, in most cases a 529 plan will work better. ●

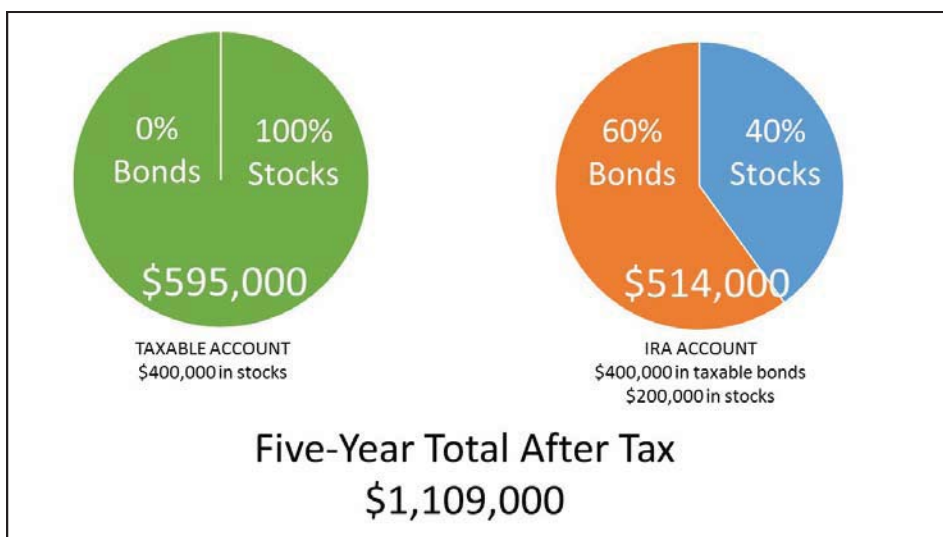


Optimizing A Retirement Portfolio

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mean holding \$400,000 in bonds and \$200,000 in stocks. Instead of a 60% stock and 40% bond allocation, the IRA would hold the reverse — 40% in stocks and 60% in bonds.

The bottom line: \$1,109,000 expected value on the total portfolio after five years versus \$1,089,000. Getting an extra 2% — \$20,000 — over five years on a \$1-million portfolio may seem insignificant, but it compounds without being taxed every year in the IRA. After 10 or 20 years, tax-advantaged compounding becomes so powerful it prompted Albert Einstein to say, “Compound interest is the eighth



wonder of the world.”

Because of the long-term nature of this strategy, getting started on the

right course soon is wise. If you have questions about tax optimization, please contact us. ●